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External Debt as a Fundamental Problem for Developing Countries

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Abstract

This paper analyses the determinants of long term external debt for a large sample of developing countries. We found that, in addition to the standard economic variables, institutional and socio-political variables are a key factor in explaining the level of external debt. In fact, the international debt crisis was caused when a large number of poor countries were not able to pay the interest rates for their foreign debt Through a strategic approach we provide recommendations, guidelines and suggestions to overcome and resolve the external debt of developing countries, as key issue in the global economy.

Key words: external debt; developing countries; financial architecture; world economy.

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1. The international debt and the debt crisis

The debt crisis of developing countries has its roots from the rise in oil prices by OPEC in 1973 and in 1979. This resulted in massive flows of funds from major oil importers (USA, Japan, Germany) in to the oil producing countries, OPEC members. Commercial banks entered the scene taking advantage of this money, loaning countries of OPEC lending governments and businesses all around the world. Loans were approved on the basis of optimistic forecasts about the prospects for growth in these countries, which did not materialize. Instead, the economic growth of the developing countries was suppressed at the beginning of the eighties by a combination of factors, which include high inflation, rise of short-term interest rates (which increased the cost of debt servicing), and situation of recession in many developed countries (which were markets for the developing countries). Actually developing countries rely on capital inflows from abroad to finance their domestic investments.

As a consequence of this is the debt crisis of massive proportions in developing countries, Where these countries amassed enormously large debt towards developed world. This is displayed by the data in tables 1 and 2:

Table 1. The foreign debt of developing countries between 1990 and 2010 in billion $

	1990	2000	2010
Total debt (billion USD)	1156,5	1461,0	1942,3
Total debt by regions (billion USD)			
Africa	203,0	259,0	288,1
Asia	317,6	455,3	663,2
Middle East/Europe	209,3	208,1	256,6
Western Hemisphere	426,7	538,6	734,4
Foreign debt and GDP Ratio	40,6%	37,3%	35,1%
Foreign debt and export of goods and services Ratio	171,1%	192,8%	158,1%
Debt repayment and export of goods Ratio	9,1%	9,3%	9,1%

Source: [8]

Table 2. The foreign debt of the developing countries by categories and creditors in billion $

Position	1997	2004	2006	2008
By the term maturity				
Short-term debt	352,4	418,9	508,9	517,1
Long-term debt	1.964,3	2.475,9	2.697,4	2.701,3
By the type of the credit				
Public creditors	947,2	1.020,5	1.023,7	1.024,2
Banks	715,8	788,0	921,6	927,3
Other private creditors	650,5	1.066,0	1.236,9	1.240,4

Source: [9]

In fact, the international debt crisis was caused when a large number of poor countries were not able to pay the interest rates for their foreign debt. After all, the debt weighs only when the real interest rate is positive, then a country have to sacrifice real resources to repay the debt in the future. Crucial cause of the debt crisis after 1985 is the increase in real interest rates. In fact, in most of previous decades the real interest rates were negative, and countries debtors were subsidized by the creditors. Namely simultaneously with the inflow of foreign capital on various grounds was increasing their indebtedness towards abroad as well. The external debt of the economies of developing countries for 1997 was 2318.1 billion dollars, and in 2012 was 3351.2 [1]. Upon the displayed data all prospects for escalating of the external indebtedness in developing countries always exist, even in a limited scale, although the international creditors and international financial institutions now are more ready than ever and with more experience to deal with foreign debt, than it was the case before. In addition to that goes the debt forgiveness for the poorest countries and certain "package" of financial aid and rescheduling of debts that are coordinated in case for individual countries. Namely, this problem requires global solutions and interventions and that's something that has opposition in the big capital because it does not want to lose the opportunity for large profits. Any attempt to regulate international economic relations by the big capital and its holders is perceived as a blow to their interests. However, despite their strong opposition, it is necessary institutionalization of international economic institutions for the external debt as well something that would simultaneously mean a constructive solution to this problem.

2. The contemporary debt crisis and the need of reform of the international financial architecture

More emphatically in recent years, it is equally stressed this or that destructive component of – without no doubt the widespread global - financial turmoil of the new generation: the accelerated liberalization of the international movement of capital, speculative impacts on national financial systems, massive capital escaping, recessions, self-sustaining crisis of distrust in debtors, countries or the markets themselves. Inadequate, slow and / or insufficient response of the multilateral financial institutions in the cases of Mexico, Brazil, Russia and Southeast Asia, and consequently the significant loss of global wealth from developing countries outside of the aforementioned regions pointed to serious weaknesses in the international financial system. Inadequate, slow and / or insufficient response of the multilateral financial institutions in the cases of Mexico, Brazil, Russia and Southeast Asia, and consequently the significant loss of global wealth from developing countries outside of the aforementioned regions pointed to serious weaknesses in the international financial system. The inadequate, slow and/or insufficient response of the multilateral financial institutions in the cases of Mexico, Brazil, Russia and Southeast Asia, as well as consequently significant loss of global wealth from developing countries outside of the aforementioned regions pointed out to serious weaknesses in the international financial system. Moreover, the strong and astonishing ability of spreading of the increased regional financial crises inevitably creates fear of an outbreak of a new, and by the magnitude and duration by more comprehensive, debt crisis.

In literature have appeared almost nearly a hundred articles on the sources and the anatomy of the financial crisis of liquidity. Montiel and Tornell say that financial liberalization and completely rampant borrowing by companies (and countries) abroad, replacing investments, yielded an unproductive consumer stampede.

Krugman emphasized the overvalued domestic currencies unjustified fixed to the dollar, while Williams and Rodrik emphasize the poor, extremely short-term structure of the corporate sources of funding [2], in a much longer period before the outbreak of the crisis.

In fact, even from the harshest cross section is visible the connection and supplementary of the various explanations of causal heuristics of recent financial crises, which increases the impression of actuality of the still heated debate on the subject, but by that does not refute the fact that all crises ultimately resulted in acute indebtedness of the affected economies and a dramatic decline in the credit rating of countries. The exports of financial panic and recessionary multiregional shifts in multiregional scale, as a by-product of new debt crisis, only accelerated discontent creditor part of the world, which together with the large debtors, transition countries and with the crisis affected countries, had by itself responded with an ask (and proposals) to reform the international financial architecture.

The so far discourses about the need for a new international financial architecture lie in the following general guidelines [3]:

- accounting standards and transparency;
- financial regulation and supervision;
- prudent capital management of the balance of payments;
- exchange rate regimes;
- international monitoring of national macroeconomic policies;
- providing a new (enough plentiful) source of international liquidity;
- systematic and procedural facing with problems of servicing the external debt.

From all above mentioned guidelines our attention will focus on segments that are in unequivocal connection with the issues of external debt management. Unfortunately, there are also evident the tracks where are made at least reforms. What is within the IMF, BIS Bank and the newly created Financial Stability Forum (FSF) despite set of reformist proposals accepted, could be reduced to the first and (and to a lesser extent) the second specified area of modernization of the global financial architecture. Many of the big ideas with essentially modified approach to the unraveling of the financial crises and the unraveling of the problem of excessive external indebtedness, had not even broke in the sum of preliminary proposals for consideration, probably because the leaderships of the leading countries in the world, above all those from the G7, considered them too radical, and therefore unworthy for them to pay any attention.

However, despite the conspicuous institutional gaps and functional contradictions, the irreconcilable antagonism of the political and the economic interests of the international (financial) community still remains a major limiting factor for more decisive and effective progress in this field. Of course, political disagreements do not concentrate only on the international debt-trust axis, because obviously there are major differences between the members of the G-8 as well, in the view of the nature and direction of necessary reforms. But somewhere are showed brighter views about this question: it can happen to us at the beginning of the 21st century a real institutional reforms (with worldwide scales) to seem quite impossible, just till the moment when they actually occur. “After one or two crises, the impossible will begin to seem possible”.

3. Recommendations and opportunities for overcoming the problems with external debt in developing countries

The final goal of the strategic management of external debt, solely has to be seen in the maximum capture of the economical and developmental usages from the borrowing from abroad, by simultaneous avoidance of the problems of macroeconomic instability and instability in Balance of payments. Like other indebted countries which are in a similar situation, and especially when developing countries are trying to provide the (necessarily) significant portion of its capital formation abroad, they will have to cover in detail all three lines of external debt management [4]:

a. maintenance and development of statistics on external debt;

b. simulation analysis of the country's capacity to service its debt;

c. coordination of institutions that manage the external debt and macroeconomic policies that (in)directly affect the external debt.

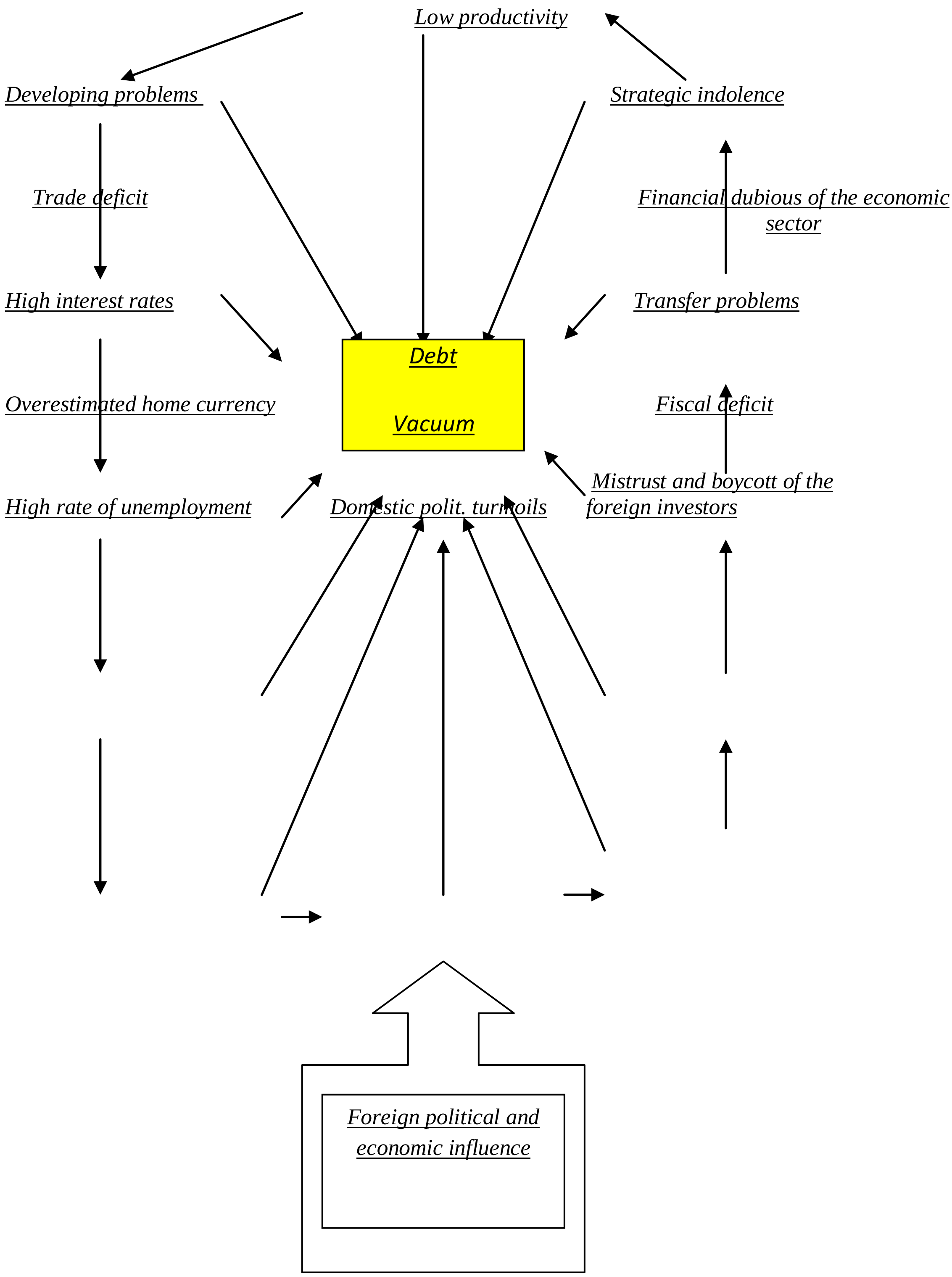
The so far debt problems of developing countries can roughly be summarized with figure 1 [5].

In fact, along with fundamental macroeconomic problems and the need for immediate major foreign lending to national economies in developing countries, taking into account the relationship between the developing countries and the international community, would have to contend with the obligation to return [4] or consolidate the previously piled debts. The recommendations that should be given to the developing countries on the occasion of the future management of external debt, are substantially complementary to the priority moves that highlights relevant international institutional framework. This in other words means that mistakes and failures in managing external debt in developing countries (once again) had resulted from the absence of a strategic approach to this important segment of macroeconomic management, as for these countries and for all entities in the world economy.

The strategic approach to the issue of borrowing abroad and the overcoming of the crisis with foreign debt and simultaneously for preventing of a new indebtedness crisis in developing countries needs a global incorporation of the following guidelines:

A. The strategy of economic development must first be preceded by a strategy of managing external debt, then these two strategies must simultaneously be conducted or reviewed. In order for dynamic economic growth and its increasing rate, which the developing countries are more than needed. Starting from here, is crucial to set up, aggressive, consistent and long-term reform strategy of export-oriented development, which will incorporate the growing limitations of time and material resources of the developing countries. There must be harmonized and completely dedicated to it strategy of borrowing abroad and managing external debt in these countries.

figure 1. Problems with the foreign debt in the developing countries



Source: [7]

B. There should be a precise and legally founded coordination and cooperation between government agencies involved in foreign borrowing and debt management. Namely, the state at any time would be aware of the scope and structure of its financial obligations abroad. Today, in many indebted countries, beside the ministry(ies) of finance, the central bank and the ministry of planning and development, have the right on behalf of the state to borrow or somehow alter the amount and structure of external debt, also there many state or parastatal or legal entities to the level (national, social) of enterprise. Bearing in mind that, to avoid frequent borrowing, without prior notice or consent from the competent authorities, as well as towards how to implement effective single policy of borrowing and managing with the scope and terms of the assumed debt, it is necessary functional but also a formal and legal synchronization of state centers in terms of deciding on the matter.

C. While it may be endangered from outside, the solvency of the debtor fosters from "home". The external borrowing in globalized financial environment is inherently dynamic activity that economic officials before the indebted countries set the task of maintaining the solvency of the state under a wide range of potential (negative) activities. The poor interest and currency composition of external debt was often a factor of inducing or accelerating the debt crises. Furthermore, the strategic management of external debt is that which provides the greatest amount of foreign loans: the states need more loans than they can afford. Also, strategic debt management is not one that provides the lowest cost of external debt: to minimize the risks of external debt has recently become at least as important. In this connection, the IMF promoted a whole range of additional indicators of external economic vulnerability of the debtors (as was pointed out above), which is in a function of the prudent financial management and warning from crisis, in both the private and public sector. Besides monitoring the effectiveness/efficiency of the use of foreign loans and managing multidimensional structure of external debt, in the common practice of strategic debt management must be implemented and specified tests with which by a simulation must examined the development performances and the ability of the debtor to recover the loan.

So, although the global shocks (such as world recession, reluctance among international capital flows, etc..) can initiate financial crisis, the prudent external debt management minimizes the debtors susceptibility to its manifestation shapes, and more importantly, it represents the only base out of the crisis. However, sound economic management of the debt cannot be a substitute for proper leaded and well co-ordinate monetary, fiscal and exchange rate policy. The intrinsic solvency of borrowers is based on their ability to earn income. From here, the complete establishment of economic and technical capacities for strategic management of the external debt in the developing countries may take several years, given the limitations that still characterize the country in the field of quality and compatibility of macroeconomic policies, (non)development of the financial market, institutional capacity for designing and implementing reforms, the exchange rate regime, the country's credit risk, etc..

D. The fiscal balance is crucial for the successful management of external debt. Masterly designed fiscal policy in the area of taxation, tax exemptions and state expenditures [6], with a decisive strategy of economic development play an important role in the fiscal capturing of newly created value and repayment of the country. On the other hand, inconsistent, poorly formulated fiscal policies intensify the debt crisis, adding "oil"-the internal transfer problem (taxation of private sector for funding of the public sector) to "fire"-the external transfer problem (raising export earnings for servicing the external debt). Finally, the agencies responsible for managing external debt if necessary should warn the government against the impact of its credit and emission requirements on (progressively increasing) costs of external borrowing.

E. Exemptions from the rule for emphasized transparency of the external debt and the mandatory publication of statistics on unsettled foreign debt can exist only in exceptional cases. The role and the objectives of management of external debt should be clearly defined, known and understandable to the general public, because the experiences shows that it strengthens the credibility of the policy external borrowing and maintains the consensus around the willingness to repay debt. In the case of the developing countries the unconventional conspiracy in connection with the current external debt was already a long tradition, even when it comes to the professional (official!) curiosity of economists.

F. Should not be missed that in the management of external debt, politics and law often dominate the economy. In international (economic) relations, covered or little bit discreetly but inevitably pervades the irreconcilable antagonism of interests. Strategic actions arising from conflicting (but variable) interest, deepened by military-political, economic and psychological character of the negotiator, it is necessary constantly to be taken into account in the limits of the possibilities to measure their intensity and impact on outcomes of debtor-creditor interactions. Debt crisis despite economic also have technical and legal dimensions. The knowledge of the international credit clauses and special attention in their implementation, include a top legal expertise whose existence does not necessarily provide a relative advantage, but whose absence as a rule in the actual start brings risk of inferiority for the borrower and narrows his maneuvering space for successful management.

G. The academic debate in the field of economics and external borrowing encourages and promotes the instruments, arrangements and solutions encountered in practice, and therefore they cannot be ignored. The intense analytical debate in scientific circles, political forums, and within the relevant international financial institutions played a crucial role in formulating the strategy for exit from the global and regional debt crisis. On the other hand, the indebted developing countries, often made mistakes or been missing chances to advance their debt positions, just because their external debt was managing by individuals and institutions without sufficient knowledge of this crucial and vital area of international finance.

4. Conclusion

Based on the things said above we can conclude that external debt is one of the key problems in the global economy, particularly for developing countries. Having that in mind, adequate strategic ways are necessary in order to allow these countries to get out of chronic debt crisis. Possible failure of the strategy, the economic stagnation or lack of quality in economic development in these countries would mean further debt agony. On the contrary, the strategic analysis of the external debt and the rational management of external debt could be a strong ally of the well planned and decisive economic reform in developing countries. Short sighted, superficial and crude management of external debt, in developing countries are enough for their departure from the economic growth and development.

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